Moody's Investors Service

Global Credit Research
Rating Update
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Rating Update: **California (State of)**

MOODY'S DOWNGRADES CALIFORNIA'S BOND RATING TO Baa1 FROM A3; RATING OUTLOOK REMAINS NEGATIVE

State
CA

Opinion

NEW YORK, Dec 9, 2003 – Moody's Investors Service downgraded the State of California's General Obligation Bond rating to Baa1 from A3, and also downgraded the state's General Fund-supported lease revenue bonds and General Fund-enhanced tobacco bonds to Baa2 from Baa1. The rating outlook for all of these bonds remains negative. The downgrade reflects the state's recent action to cut the Vehicle License Fee (VLF), with immediate effect, as well as the continuing inability to reach political consensus on solutions to its budget and financial problems. The VLF action is expected to significantly increase what is already projected to be a very substantial fiscal deficit over the next eighteen months.

By Moody's calculation, the VLF reduction increases the projected cumulative General Fund cash shortfall through June 2005 from about $22 billion to roughly $29.5 billion, excluding any proactive budget adjustments that may be passed and any proceeds from and debt service on long-term deficit bonds. This estimate assumes that the state's General Fund will be required to substantially make up the local government revenue loss resulting from the VLF cut. While this is yet to be authorized by the legislature, we view it as an accumulating liability of the state that will eventually be authorized.

STATE'S CASH NEEDS IMPLY SIGNIFICANT ONGOING RELIANCE ON LONG-TERM AND SHORT-TERM CAPITAL MARKETS. PROGRESS ON $10.7 BILLION FISCAL RECOVERY BONDS IS CRUCIAL.

As discussed in our prior reports - see our New Issue Report dated October 24 for more detailed commentary – the General Fund's cash needs to date have been largely funded with short-term debt, with some $14 billion of notes and warrants maturing in June 2004. Given this, and the continuing cash imbalance projected in fiscal 2005, we expect the state will remain reliant on significant financial assistance from the capital markets, in the form of both long-term deficit bonds and additional short-term borrowing structures. In this light, the recent move to increase rather than decrease the General Fund's cash consumption, and the deep political disagreement over a way out of the state's fiscal dilemma, are not encouraging.

Crucial to the state's cash management plan in the near-term is the $10.7 billion Fiscal Recovery Bond that was authorized as part of the originally adopted fiscal 2004 budget. This financing took a step forward last week with the borrowing Authority's adoption of financing agreements and approval of a court validation filing. The financing structure involved is legally innovative for California, and is already the subject of a legal challenge on state constitutional grounds (though filed prematurely, the initial challenge will likely be revived). Both the state's Attorney General and its bond counsel have opined, however, that the financing is valid.

The bond financing schedule has not been set back significantly by the gubernatorial transition, although we note that the schedule is only an estimate due to the uncertainties of the court process. In our view, there remains a good chance of completing the legal hurdles and issuing the bonds by June 2004, in time to assist with the repayment of maturing short-term debt. If the bond plan is delayed, or terminated by the courts, the state will attempt to complete a short-term debt rollover. Any change in our opinion of the state's ability to complete the bonds and/or a short-term debt rollover will likely place additional negative pressure on the state's credit rating.

The state's existing public-market, short-term debt is not at risk of default, in Moody's view, due to the presence of committed bank facilities. Ratings on this enhanced debt are affirmed at MIG 1.

RECENT FINANCIAL WEAKENING HAS FAR OUTWEIGHED ECONOMIC DECLINE

California's bond rating downgrades of the past year have been driven by its declining financial position, rather than any reassessment of the state's fundamental, longer-term economic strengths. The state's large, diversified, and wealthy economy has in fact performed close to that of the nation over recent years. Although the northern part of the state has struggled with a sharp downturn in the high-tech sector, private-sector employment statewide has declined by a fairly moderate 2.4% from its mid-2001 peak, including an estimated decline of less than 0.5% over the last twelve months ended October 2003. The U.S. has lost a similar 2.3% of its private-sector job base since the recent peak. Recent moderate increases in the state's tax revenue forecasts for 2004 and 2005 underscore the continuing resilience and performance of the economy.

Outlook

California's bond rating outlook remains negative, in view of its weak liquidity position and exposure to market refinancing risk. The key consideration for the state's rating in the months ahead will be progress on implementation of the strategy to replace short-term debt maturing in June 2004 with longer-term deficit financing. The rating outlook will also depend on whether the state can develop credible contingency cash management plans in the event that the long-term financing is delayed due to legal challenges.

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